THE GROWTH OF FINANCIAL BANKING

Statistical evidence, supplemented by the testimony of several bankers of high standing, would indicate that the banks of the country are each year investing less freely in commercial paper, while the bonds, stocks, and other securities owned and the "call" loans on collateral represent a steadily increasing percentage of their assets.

The total amount of bonds, stocks, and other securities held by all the banks (other than savings banks) reporting to the comptroller of the currency in 1905 was approximately $1,874,000,000[1]—a sum equal to 22.43 per cent. of the individual deposits of such banks. The investments of the national banks alone bore a ratio of 17.18 per cent. to their individual deposits, while for the state and private banks, and loan and trust companies, reporting, the ratios were 17.27, 10.29, and 39.68 per cent. respectively.

The figures for the sixteen years preceding 1905 showing the ratios of the aggregate investment in bonds, stocks, and other securities (United States bonds excluded), to the aggregate individual deposits of the national, state, and private banks, and loan and trust

[1] No adequate data concerning the nature of the bonds, stocks, and other securities held by the banks are furnished by the comptroller, and there are no other reliable sources of information. Nevertheless even the incomplete classification of investment items published in the report of the comptroller is significant. The unclassified bonds, stocks, and other securities held by 9,505 state and private banks, loan and trust companies, of the United States about June 30, 1905, amounted to $1,132,000,000 (exclusive of United States, state, county, and municipal bonds, railway bonds and stock, and bank stock). No doubt many of the unclassified items belonged under the excluded heads, being marked "unclassified" through lack of information. At the same time, the bond and stock holding (exclusive of United States bonds) of the national banks exceeded $677,000,000. A classified table of bond investments alone has been prepared by Mr. William C. Cornwall, of the banking house of J. S. Bache & Co. (*Bonds as a Safety Reserve for Banks*). He has based his estimates of the total bond holdings of the national and state banks and trust companies of the United States upon returns received from about 4,000 banks giving information as to the amount and character of bonds held by them. Out of a total estimated bond investment of approximately $1,770,000,000, the railway bonds amount to $915,000,000, the municipal bonds to $513,000,000, and the miscellaneous bonds to $286,000,000. It is interesting to know that out of these $286,000,000 of miscellaneous bonds, $47,000,000 were held by banks in New York City, and $30,400,000 by banks in Philadelphia. In view of the large percentage of investments admitted to no definite classification, there is a wide field for conjecture as to the character and the diversity of the interests that they represent; and any conclusions that may be reached on this subject must, in the nature of the case, be arrived at by inference from certain known, presumably related, facts.

companies, reporting to the comptroller within that period, are as follows:

1889 .... 8.25%	1894 .... 13.96%	1898 .... 14.58%	1902 .... 18.25%
1890 .... 8.94%	1895 .... 14.04%	1899 .... 15.79%	1903 .... 20.4 %
1891 .... 9.48%	1896 .... 15.37%	1900 .... 17.66%	1904 .... 21.95%
1892 .... 10.14%	1897 .... 14.95%	1901 .... 18.03%	1905 .... 22.43%
1893 .... 12.41%			

The percentages for the national banks alone are somewhat lower:

1889 .... 7.18%	1894 .... 11.09%	1898 .... 12.11%	1902 .... 14.79%
1890 .... 7.24%	1895 .... 11.36%	1899 .... 12.66%	1903 .... 15.69%
1891 .... 7.78%	1896 .... 11.71%	1900 .... 14.11%	1904 .... 16.5 %
1892 .... 8.68%	1897 .... 11.16%	1901 .... 14.73%	1905 .... 17.18%
1893 .... 10.14%			

Considering the rapid advance shown in the percentage of direct investments in stocks and bonds to individual deposits, and taking into account the fact that all increasing proportion of these individual deposits grow out of loans on stock-exchange collateral,[2] it becomes at once apparent that investments in commercial paper are each year decreasing in relative importance.

It should be noticed that even during the period of liquidation and depression lasting from 1893 to 1897 the banks continued to enlarge the proportion of their stock and bond investments, while with the return of more prosperous conditions in 1897 a fall in the ratio took place, followed, however, by a quick recovery and a subsequent sustained advance. It is probable that after the panic of 1893 the banks, though continuing to contract their general operations and busily accumulating a surplus reserve, were unable to dispose of their stock and bond holdings to any extent, given the unfavorable financial conditions, while at the same time they were no doubt compelled to take over large amounts of securities held as collateral in lieu of the payment of loans. In consequence a certain amount of these securities would be disposed of as soon as a market for them could be found, and the general movement toward increased investments in corporate issues would thereby suffer a temporary check.

The marked advance in the percentage of "stocks, securities, etc.," to capital, surplus, and undivided profits furnishes additional corroboration of the growing importance of such investments. The figures for the national banks taken for a series of years indicate an astonishing rate of increase:

[2] Cf. p. 3.

THE RATIO OF THE "STOCKS, SECURITIES, ETC.," HELD BY THE NATIONAL BANKS OF THE U. S. TO THEIR CAPITAL, SURPLUS AND UNDIVIDED PROFITS

1889	12.21%	1894	19.27%	1898	26.52%	1902	41.05%
1890	12.02%	1895	19.61%	1899	33.5 %	1903	39.59%
1891	12.41%	1896	19.19%	1900	36. %	1904	43.52%
1892	15.04%	1897	21.61%	1901	41.31%	1905	46.98%
1893	14.44%						

For the state banks alone the stock and bond investments in 1905 were equivalent to 68.37 per cent. of their capital, surplus and undivided profits; for the private banks the ratio was 40.73 per cent.; while for the loan and trust companies it rose to 129.56 per cent.

A pronounced tendency of present-day banking is found in the relative decrease in the size of the capital account compared with the magnitude of the general business that is carried on.[3] As the operations conducted by the banks upon a given capital continue to become more extensive, the greater the necessity under which they lie of having their assets in forms capable of safe and easy liquidations. In view of this fact, the figures showing the high percentage of stock and bond investments to total capital, surplus, and undivided profits become highly significant. As to how far such investments can be utilized to meet the need for readily convertible assets is a question to be discussed later.

Demand loans protected by a pledge of "stocks, bonds, and other personal securities" also give employment to a much larger proportion of the resources of banks than formerly. The ratio of these demand loans to the total loans of the national banks of the United States, and of New York City, for a series of years are as follows:

1889	14.08%	1894	13.81%	1898	17. 22%	1902	21.54%
1890	13.79%	1895	13.91%	1899	22. 14%	1903	20.6 %
1891	13.38%	1896	13.81%	1900	21. 45%	1904	21.91%
1892	12.69%	1897	15.91%	1901	22. 05%	1905	21.36%
1893	13.99%						

THE RATIO OF THE DEMAND LOANS SECURED BY "STOCKS, BONDS, AND OTHER PERSONAL SECURITIES" TO THE TOTAL LOANS OF THE NATIONAL BANKS OF NEW YORK CITY

1889	35.99%	1894	32.06%	1898	38.53%	1902	43.45%
1890	34.45%	1895	32.62%	1899	42.09%	1903	44.56%
1891	37.73%	1896	32.61%	1900	44.72%	1904	48.58%
1892	34.21%	1897	35.51%	1901	44.37%	1905	47.86%
1893	33.41%						

[3] On this point see Cleveland, *The Bank and the Treasury,* p. 5; also chart opposite p. 8.

The national banks of New York City show considerably higher percentages, the funds deposited with them by outside banks helping to swell the total amount of such loans.

If it is borne in mind that "call" loans are employed almost exclusively in stock-exchange transactions, and that stock-exchange securities are in nearly all cases pledged to their redemption, then the statistics given make it possible to conceive of the immense indirect interest which the banks (especially those of New York City) have in speculative operations. No account has been taken, moreover, of the collateral loans on time, many of which are secured for the purpose of carrying through sustained speculative and financial operations.

Notwithstanding the incomplete nature of the evidence adduced, it fairly well demonstrates the radical change in banking methods that has been taking place during the last ten or fifteen years. The reasons for such a change, however, furnish occasion for disagreement. Have the banks deliberately branched out into a new field of activity? Have the exigencies of the modern industrial situation of corporate organization and control forced a departure from the older forms of commercial banking? Or has the pressure come from certain individuals who have effected an entrance into the banks for the purpose of directing their resources into channels advantageous to themselves? A deal of adverse comment is preferred against the banks for engaging in, what has been aptly termed "financial," in contradistinction to commercial, banking. In general, critics have proceeded on the assumption that the promoter and the speculator on the one hand, and the banker on the other, are to be conceived of as distinct personalities; and they regard any community of interests that may exist among these individuals as having grown out of an illegitimate expansion of banking activity, initiated in the first instance by the banks themselves. Even when a change in banking practice is recognized and upheld as the result of a change in the modern industrial organization, the banks are still regarded as more or less independent agents actively extending the range of their influence and enlarging the number of their interests. There is considerable evidence, however, to support the statement that the banks, far from acting independently, operate as part of a larger industrial and financial whole, and that the union of the principal banking, trust, and insurance companies of the country, which has progressed so rapidly of

late years, merely reflects the trend of development of this more comprehensive alliance. It is, in fact, but one aspect of the general movement toward an extension of investment interests together with a concentration of group control which has been so characteristic of the past decade. It is the necessary consequence, as it is the essential condition, of the effectual carrying through by large groups of investors of big railroad and industrial enterprises. Each group has its own financial backing which it brings to the support of any undertaking, and when several groups combine, their several financial interests also become allied.

From the point of view, then, of the financiers in control, the banks are but tools for the legitimate furtherance of certain ulterior ends. As promoters and underwriters, these men are impelled to find a market for the stock and bond issues of the companies they foster, and they are greatly concerned in the maintenance and advance of the prices of such stocks and bonds. Hence it is that the banks are to be found investing largely in corporate issues. For these reasons they underwrite securities; effect more or less permanent as well as temporary purchases to relieve a "congestion" in the stock market; grant loans to corporations, receiving their evidences of debt as collateral; and make advances to speculators, who in some instance are in control of the banks extending the loans.[4]

But the reasons just advanced are not those generally alleged to be responsible for the accelerated investment in stocks and bonds. It is said to be caused in part by the difficulty encountered in obtaining good commercial paper to discount. The implication is that the trusts have absorbed the most prosperous and the safest of the

[4] The National City Bank may be cited as an illustration of an institution dominated by financiers rather than bankers, proper. It was not until the Standard Oil group had developed into a fairly important investment power that the National City Bank began to be generally identified with it (1893 or 1894). By that time the interests of the group were sufficiently extensive to make the control of such a financial agent highly desirable. Standard Oil men were in control of rich ore properties (the Minnesota Iron Co. and the Lake Superior Consolidated Iron Mines Co., for example). They were in western railroads, such as the Northern Pacific and the Missouri, Kansas & Texas. They had holdings in eastern roads (the New York, New Haven & Hartford, the Ohio River Railroad Co., and the Delaware Lackawanna Western). Some of the group were identified with the National Lead Co., and others with the American Cotton Oil Co., while a few were beginning to be interested in street-railway and electric-lighting properties. As Standard Oil men continued to extend the scope of their investment activities and came into increasingly closer contact with other large financial groups it followed as a matter of course that the National City Bank should extend its connections. In May, 1897, it absorbed the Third National Bank of New York; in February, 1898, it secured control of the Second National; in March, 1900, the Fidelity National

present-day firms—those whose paper would be worthy of acceptance, in short. There are, to be sure, no available statistics regarding the amount of commercial paper of good character waiting to be discounted in any community, but complaints are not wanting that the banks have at times disregarded the legitimate demands of applicants for commercial loans because they had utilized their resources in purchases of stocks and bonds and in loans on collateral made in the interest of important financial groups.[5]

The main plea, however, urged in favor of both direct and indirect investments in corporate securities is that they are peculiarly safe assets because of the facility with which they can be turned into cash in case of emergency. For the individual bank, it is true, such holdings afford a means of realizing quickly in time of need. Under favorable circumstances they are no doubt superior in this respect to commercial paper having from thirty to ninety days or even longer to run, since stocks and bonds (long-time obligations of their issuers though they be) can usually find a ready market. Collateral loans payable on demand are also easily collectible so long as the speculator to whom the loan has been granted can obtain accommodation elsewhere. But what will be the result of an attempt on the part of all the banks to liquidate, as in times of crisis? To what extent will they be able to convert their standard investment securities (their so-called second reserves) into cash? How far will they be able to protect themselves by calling in their loans on collateral? It has already been stated that during the period of financial depression

was launched as a National City concern. In May the Bank of the Metropolis became allied, and in August of the same year it was reported that 1,000 shares of the Lincoln National had been bought. In June, 1901, interests connected with the National City began negotiating for control of the Columbia Bank, which was finally secured, as was the National Butchers' and Drovers' the following November. It is significant that this remarkably rapid expansion should have taken place during the period of greatest trust-building activity (1897–1901).

On the directorate of the National City itself various important financial interests have come to be represented, and one or more of its directors are to be found on the boards of at least thirty-three prominent banks and trust companies of New York, and thirteen or more insurance companies, among them the three largest. It is also a matter of common knowledge that the so-called "Morgan banks" have intimate working arrangements with the Standard Oil financial institutions, and that a practically endless chain of alliances is being established through an interchange of directors as well as a shifting of stock-ownership.

[5] On this point cf. Cleveland, *The Bank and the Treasury*, chap. 11, pp. 149, 155, 156, W. R. Lawson, "The New York Banks, and the Treasury," *Bankers' Magazine* (London), November, 1902, p. 574; A. S. Bolles, "The Responsibility of the National Bank in the Present Crisis," *Annals of the American Academy*, November, 1902.

that occurred in the nineties, the proportion of bank investments in bonds, stocks, and other securities continued to increase, declining for a time with the return of better conditions; and it was then suggested that possibly the banks had not found these securities so readily convertible in a period of general need as they had thought.

Suppose, however, a bank does attempt to market its holdings in times of pressure. Other banks will be trying to do likewise, and their concerted action will undoubtedly have a depressing effect on the values of securities in general. Moreover, rising interest rates will lead to a heavy unloading by speculators of stocks carried on borrowed money, thus serving to add to the selling pressure. On the other hand, buyers will be few, and, in view of the high interest rates obtainable, the amounts they will be willing to pay for securities bearing a fixed rate of interest will in consequence be lower. Clearly a would-be seller is at a great disadvantage, and it is highly probable that under such circumstances the banks will deem it a wise policy to refrain from attempts to convert their "second reserves."[6]

Furthermore, if the banks try to strengthen their position by calling in their loans on collateral, many borrowers will be compelled to sell securities in order to obtain means of payment, thus assisting the process of price demoralization; or the banks may be left with the pledged securities on their hands to dispose of as they will. If they make efforts to sell this forfeited collateral, a further break in prices will ensue. Meantime the steady fall in values necessitates a call for additional collateral to support existing loans. The demand cannot be met in all cases, with the result that more stock already depreciated will be thrown on the market, or else the banks will choose the lesser evil of carrying loans with inadequate security back of them. They will be hit doubly hard if they refuse accommodation to customers carrying lines of securities in which they themselves are interested. If these customers are at the same time influential financiers, having a voice in their own management or that of allied institutions, there is no question as to the course of action to be taken—the banks must see them through at all hazards.

[6] "As to state banks, private banks, and trust companies, it is shown that a large proportion of the securities owned are in forms not easily marketable when occasion required. The national banks have no published statistics of the proportion of the several classes of stocks, securities, etc. It is, however, shown that about one-half the capital and surplus is invested in stocks, bonds, and other securities; it is also shown that the assets yield little support to the credit accounts in time of emergency or extraordinary money demand."—F. A. Cleveland, *The Bank and the Treasury,* chap. 9, p. 120.

That they do not refuse to extend loans freely under such circumstances has been demonstrated several times of late, when the prices of certain leading stock-exchange securities have been maintained in the face of extraordinary high interest rates.[7]

At such periods a vast deal is said concerning the necessity of keeping up the "values" of securities, and, as has been previously shown, there is no doubt that, for a speculator operating for a rise, the bank performs an admirable service, in so far as it assists an advance or prevents a decline in the price of the stock he is carrying. Just so far as the banks themselves are identified with speculative activities, whether directly by purchase or indirectly through loans on stock-exchange collateral, it is to their interest to abet the movement toward a higher price-level. Otherwise it is difficult to understand just what degree of benefit attaches to them through the use of their resources in furtherance of the price-making process. They are not helped to the extent that their securities are held as investments. If, however, they have bought at one price and are unable to dispose of their holdings at a higher, they profit by that much. But if all the items included under the head of "stocks, securities, etc.," are the gilt-edged investments they purport to be, the fluctuations of price in ordinary times ought to be confined within narrow limits.[8] In any case, the ultimate convertibility of their resources, not speculative buying and selling, should be the concern of the banks. But conversion on a scale of any magnitude at prices arrived at through operations designed to bring about an advance is highly improbable. In short, a price-level attained by a series of careful purchases and liberal credit extensions must be constantly advanced by a sort of continuous process, if the only alternative—a sharp decline—is to be avoided. No doubt a judicious application of banking resources, such as has been indicated, may lead to an

[7] Cf. W. R. Lawson, "The New York Banks and the Treasury," *Bankers' Magazine* (London), November, 1902; Noyes, "Finance," *Forum*, January–March, 1906.

[8] An examination of the course of prices of eighteen to twenty-one approved railway bonds from 1896 to 1906, the year 1901 being taken as the base 100, indicates a range of 91.9 (index number for 1896) to 100.6 (index number for 1902)—99 being the index number for 1905. The speculative securities show a much wider range: The "industrials" (stocks and bonds), including fifteen to twenty-four items, give 75 (index number for 1896) as the lowest point, and 105.4 (index number for 1905) as the highest point. The railway preferred stocks (sixteen to eighteen quotations) have 66.05 (index number for 1896) as the lowest point, and 121.57 (index number for 1905) as the highest.

indefinite advance in the prices of securities. But just how long the resultant condition of inflation can be supported and maintained is gravely problematical.

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PRICES, CREDIT, AND THE QUANTITY THEORY AGAIN

The appearance of Professor Joseph French Johnson's *Money and Currency* gives occasion for raising anew certain questions regarding the effect upon prices of quantity of money and credit. Professor Johnson's treatise covers a wide field, including value of money, credit, monometallism, bimetallism, domestic and foreign exchange, fiat money, and the history of money in the United States.

It may be noted in passing that on the whole, the descriptive portions of the book are well done—in some cases exceptionally well done—and though one may differ with the author on questions of theory, in most cases his position is at least clearly expressed. One or two exceptions to this will be pointed out. There seem, however, to be serious defects in the theoretical part of the discussion, and it is to these that attention is here, perhaps somewhat ungraciously, directed.

Concerning the uses of money our author declares:

> Exchangeability is the only utility possessed by money, and it is on account of this utility, and this only, that it is wanted. Money performs a specific service for men, like a hoe or a knife, and is wanted for no other purpose. (P. 11.)

Regardless of his position that money was probably used as a medium of exchange *before* it was employed as a standard of prices or value, is it true that money is wanted for example in bank reserves exclusively as a medium of exchange? Is there not rather a portion of money here which is constantly reserved from this use? Does it not serve to insure solvency of the financial institution, and to make its credit instruments acceptable? So also of the reserve held in the United States Treasury. The author would doubtless say that this use grows out of its use as a medium of exchange. Possibly; but even so it does not follow that the two uses resolve themselves into one because the second grows out of the first.